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Testimony

Of

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Before The

House Resources Committee

U.S. House of Representatives

March 19, 2003

STATEMENT

OF

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FOR

THE INDEPENDENT PETROLEUM ASSOCIATION OF AMERICA, THE AMERICAN PETROLEUM INSTITUTE, THE DOMESTIC PETROLEUM COUNCIL, THE INTERNATIONAL ASSOCIATION OF DRILLING CONTRACTORS, THE NATIONAL OCEAN INDUSTRIES ASSOCIATION, THE NATIONAL STRIPPER WELL ASSOCIATION, THE NATURAL GAS SUPPLY ASSOCIATION, THE PETROLEUM EQUIPMENT SUPPLIERS ASSOCIATION, THE US OIL & GAS ASSOCIATION, THE ASSOCIATION OF ENERGY SERVICE COMPANIES

AND

California Independent Petroleum Association

Colorado Oil & Gas Association

East Texas Producers & Royalty Owners Association

Eastern Kansas Oil & Gas Association

Florida Independent Petroleum Association

Illinois Oil & Gas Association

Independent Oil & Gas Association of New York

Independent Oil & Gas Association of Pennsylvania

Independent Oil & Gas Association of West Virginia

Independent Oil Producers Association Tri-State

Independent Petroleum Association of Mountain States

Independent Petroleum Association of New Mexico

Indiana Oil & Gas Association

Kansas Independent Oil & Gas Association

Kentucky Oil & Gas Association

Louisiana Independent Oil & Gas Association
Michigan Oil & Gas Association
Mississippi Independent Producers & Royalty Association
Montana Oil & Gas Association
National Association of Royalty Owners
Nebraska Independent Oil & Gas Association
New Mexico Oil & Gas Association
New York State Oil Producers Association
Ohio Oil & Gas Association
Oklahoma Independent Petroleum Association
Panhandle Producers & Royalty Owners Association
Pennsylvania Oil & Gas Association
Permian Basin Petroleum Association
Petroleum Association of Wyoming
Tennessee Oil & Gas Association
Texas Alliance of Energy Producers
Texas Independent Producers and Royalty Owners
Wyoming Independent Producers Association

Mister Chairman, members of the committee, I am Diemer True, Chairman of the Independent Petroleum Association of America (IPAA). This testimony is submitted on behalf of the IPAA, the American Petroleum Institute (API), the Domestic Petroleum Council (DPC), the International Association of Drilling Contractors (IADC), the National Ocean Industries Association (NOIA), the National Stripper Well Association (NSWA), the Natural Gas Supply Association (NGSA), the Petroleum Equipment Suppliers Association (PESA), the US Oil & Gas Association (USOGA), and 33 cooperating state and regional oil and gas associations. These organizations represent petroleum and natural gas producers, the segment of the industry that is affected the most when national energy policy does not recognize the importance of our own domestic resources.

This hearing addresses the need for legislation to better manage federally owned energy resources underlying federal lands. For example, the role of federal lands in meeting future oil and natural gas demand is a critical one and this hearing is a timely opportunity to address that role, the general issues surrounding oil and natural gas supply in the United States, and opportunities to improve the current processes.

Initially, it is important to put the current supply and demand situation in some perspective. The United States will remain principally dependent on oil and natural gas for the foreseeable future. Recent projections by the Energy Information Administration (EIA) show the oil and natural gas will provide for about 65 percent of domestic energy over the next several decades. Domestic import levels of oil continue to exceed 50 percent and remain a significant national security issue. While supply and demand of natural gas remains a largely North American market, without adequate access to the resource base, domestic natural gas will not be able to meet its potential. This testimony will primarily focus on the natural gas implications of the current supply, demand, and regulatory framework which affects its development. However, the access issues are the same for both oil and natural gas.

The Supply Challenge

Today's natural gas price and supply constraints are the consequences of past decisions. Going back to year-end 2000, we briefly saw the results of natural gas supply shortages. As storage dwindled, prices soared and consumers had to deal with the consequences. The initial phase of that supply-demand imbalance reflected the effects of low gas prices and unusually low oil prices in 1998-99 on capital availability to develop domestic natural gas supply. These historically low petroleum prices resulted in capital expenditure budget cuts for domestic producers exceeding 30 percent in 1999. The natural gas drilling rig count dropped by over 40 percent at its lowest point. In 1999, new wells failed to replace existing reserves.

The petroleum price recovery and the industry's recognition that future natural gas demand would increase led by more and more electricity generated by gas powered turbines triggered a robust rebound in drilling for natural gas. Rig counts went to record levels. But, the lag in new production caused by the low petroleum prices left a tight market by the end of 2000. Higher prices resulted in more drilling rigs searching for natural gas, but production still declined. U.S. natural gas production today is lower than it was five years ago.

The higher prices also reduced short-term demand. In reality, the abatement of high natural gas prices resulted from significant demand decreases not from supply increases.

In the latter months of the 2001, prices had fallen to levels comparable to the first part of 1999 and rig counts began to fall as well. By year-end 2001 rig counts had fallen to April 2000 levels. While rig counts rose to around 700, they were well below the 1000 rate that was achieved in the fall of 2001. The implication of these lower rig counts was clear – supply levels would not be sustainable.

Now, in early 2003, the implication has become reality. Natural gas supplies have been stressed by a cold winter and natural gas prices are in the range of \$6.00 per thousand cubic feet. Natural gas drilling rig counts are in the range of 750. Estimates suggest that domestic natural gas production fell by around 2.8 percent in 2002. Clearly, the challenge facing natural gas producers is twofold – maintaining existing natural gas supply and increasing that supply to meet future demand. Access to federal resources play a significant role in meeting this challenge as well as barriers to development, which also adversely affects production. This remains complicated and new events suggest a worsening situation.

Maintaining Existing Supplies

While analyses like the 1999 National Petroleum Council Natural Gas study and the newly released EPCA study by the Bureau of Land Management have focused on the resources that need to be developed to meet future demand – particularly with regard to federal lands – the challenge of maintaining existing supply has not received the attention it deserves.

The first and perhaps most compelling challenge to maintaining existing supply is coping with increasing rates of depletion. Conventional natural gas wells begin to deplete as soon as they begin to produce. But over the past decade, producers have seen average depletion rates climb from 16 percent per year to 28 percent per year. In somewhat simplified terms, this means that producers must initiate new production equal to over a quarter of existing production each year just to stay even. New technologies like 3-D seismic enable explorationists to find smaller reservoirs. Enhanced production technologies like horizontal drilling are allowing better and more environmentally effective development of reserves. But finding smaller reserves and producing them more effectively makes the challenge of maintaining existing natural gas supply more difficult.

Second, it is important to understand the extent of development of the existing resource base. Some opponents of accessing additional federal lands suggest that the current resource base should be the first focus. In reality, it already is. Developing the current resource base for both conventional and unconventional natural gas is the source of existing supply. When the rig count grew to 1000, this is where it had to grow. But this resource base has supplied natural gas for the past 50 plus years. These mature reserves are harder and more costly to develop. New reserves in these areas are smaller and deplete faster or are deeper and more costly to develop. But, there is no doubt that these resources will continue to be developed as quickly as access is provided, natural gas prices justify development and capital is available to do so.

Policymakers need to understand these implications clearly. Lower rig counts and higher depletion are adversely affecting available supply. These are the conditions that are defining the current supply and demand balance. Not only must they be addressed, but the industry must also be capable of increasing natural gas supply to meet future increased demand.

Future Supply Challenges

Despite the economic slowdown over the past year and despite the capital limitations that are devastating the merchant power industry that must invest in future electricity generation, natural gas demand will grow. Natural gas remains the most abundant and reliable clean burning fuel to meet national environmental objectives while enhancing the use of stable domestic fuel sources. National energy policy must recognize the importance of accessing the natural gas resource base. The National Petroleum Council (NPC) in transmitting its 1999 Natural Gas study concluded:

The estimated natural gas resource base is adequate to meet this increasing demand for many decades.... However, realizing the full potential for natural gas use in the United States will require focus and action on certain critical factors.

Natural gas consumption is expected to grow by almost 50 percent by 2025. While recent events may have slowed the pace of this growth – an issue that is being assessed again by the National Petroleum Council – future natural gas consumption will likely grow at a pace that will require an energy policy that allows the full potential of natural gas to be developed. This cannot be done without more access to, and development of, government-controlled resources. However, development of these resources remains a substantial challenge.

Offshore - Western and Central Gulf of Mexico

These portions of the Gulf of Mexico have proven to be a world-class area for natural gas as well as petroleum production, accounting for over 25 percent of domestic natural gas production. Production comes from the continental shelf, the deepwater, and the emerging ultra-deepwater. The NPC study projects that future production increases in these areas is essential to meet projected demand. However, future production increases will hinge on federal offshore policies. The most significant of these in the Western and Central Gulf of Mexico relate to royalty policies. However, improvements to coastal zone management review policies could also help avoid costly delays in developing new supplies.

Offshore production is particularly suited for royalty-in-kind (RIK) – paying the royalty with production instead of dollars. It is a more economical and fairer approach. Recent actions to fill the Strategic Petroleum Reserve could utilize 80 percent of this offshore royalty oil. RIK should be encouraged for natural gas. Second, the 1995 Deepwater Royalty Relief Act was extremely successful promoting activity in the deepwater Gulf. However, the 1995 program expired. Since its expiration, the Minerals Management Service (MMS) has provided more limited, but useful, royalty incentives in recent lease sales. The National Energy Policy recognized that offshore regulatory policies could inhibit the sound development of these resources. Its recommendations should be implemented and further incentives for drilling in the deepwater, deep drilling for natural gas on the shelf (including drilling on existing leases), subsalt and highly deviated drilling should be examined.

Offshore - Eastern Gulf of Mexico, Atlantic Ocean, and California

Developing the substantial domestic natural gas resources in most of these three areas is prohibited by moratoria. President Clinton extended these moratoria for another ten years in 1998 saying, "First, it is clear we must save these shores from oil drilling." This is a flawed argument ignoring the state of current technology; it results in these moratoria preventing natural gas development as well as oil. In fact, both the Eastern Gulf and the Atlantic resources are viewed as gas resource areas, not oil – those coasts are not at environmental risk. Too often, these policies are predicated on the events that occurred 30 years ago. For example, no Eastern Gulf of Mexico sale occurred from 1988 to 2001. The recent sale took place only under greatly reduced conditions.

However, this year another ominous step was taken when the federal government decided to purchase leases that have not been developed, primarily due to regulatory limitations, in the Eastern Gulf of Mexico. This action led to calls for similar purchases off the coast of California and on other government controlled land. While the merits of each case should be reviewed, following such a course also serves to limit the available resource base at a time when it needs to be expanded.

Federal policy needs to be reconsidered. It needs to be based on a sound understanding of today's technology. When the NPC analyzed natural gas resources that were being inhibited by regulation of these areas, it concluded that over 70 trillion cubic feet of natural gas in these areas are precluded from development.

Onshore Restrictions - A Mosaic of Regulations and Prohibitions

Much of the onshore natural gas resource base is located in the Intermountain West. Yet, much of this resource base is constrained. And, it is clear that this area is a critical battleground between those who seek to develop domestic natural gas and those who seek to prevent development. Not only must energy producers navigate through a mosaic of regulatory constraints, we must now deal with a series of strategic efforts to delay and prevent the necessary use of these national resources.

The regulatory framework to obtain permits to develop energy resources on federal lands is layered with complex and sometimes conflicting requirements. Federal Land Managers must operate through Resource Management Plans (RMPs) that require extensive Environmental Impact Statements (EISs). These address a wide variety of impacts regarding the use of the land. Formulating these RMPs and EISs requires consultation and, in some cases, concurrence with other federal agencies and the states. These agencies, such as the U.S. Fish and Wildlife Service, are tasked with implementing laws, like the Endangered Species Act (ESA), that do not consider the balance needed between their wildlife management objectives and national energy needs. Yet, the Federal Land Manager is developing a plan in most cases for multiple use

federal lands.

A 2003 Interior Department study confirms limitations on natural gas access in the Intermountain West. This chart shows almost 40% of federal gas resources have some barrier that prevents development.

This process creates delay, confusion, and conflict. It produces a series of access and development limitations. Collectively, the effects are significant. The NPC's Natural Gas study estimated that access to 137 trillion cubic feet of natural gas in the Intermountain West was limited by regulation. Taking a different approach, the Bureau of Land Management (BLM) released its EPCA access report and reached a conclusion that roughly 40 percent of the natural gas resources in the federal lands it studied was restricted. Moreover, these studies were largely focused on constraints that exist at the leasing phase of the process. Even in those areas where the EPCA study suggests that there are no stipulations, that assessment applies only at the leasing level. When Applications for Permits to Drill (APDs) are sought, stipulations can still be required. Such stipulations can be extensive. For example, at one southwestern Wyoming site that was analyzed, stipulations effectively limit operations to only about six weeks per year.

There are no simple answers to this issue or a single solution that will address the problems. What is required is a commitment to develop these access policies with a full recognition of the importance of developing the natural gas resource. The National Energy Policy recognized the magnitude of these limitations. Executive Orders to consider energy supply implications in federal decision making and to convene a task force to improve permitting are important first steps in developing a response. These early efforts have resulted in specific tasks within various Executive Branch departments that should improve the permitting process.

Adequate agency funding and staffing is needed at the key field offices responsible for permitting and it needs to be directed toward the permitting process. Lack of funding has limited the ability of the agencies to permit, to monitor permits, and to enforce permit requirements – leading to consequences that encourage conflicts between the different users of federal land. It has resulted in shifting the federal responsibility for developing EISs and other National Environmental Policy Act (NEPA) requirements to private parties where it was never intended to reside.

But the direct permitting aspect of addressing these access issues is only one part of a much larger debate. Besides these issues, energy producers are also confronting broad and aggressive efforts to otherwise delay or prevent access – strategies of misdirection, of litigation, and of division. Congress needs to recognize these efforts for what they are and react accordingly.

Prior to the EPCA study, development opponents consistently used a strategy of misdirection. They alternated between suggesting that the issues of federal land access were related to opening national monuments or that 95 percent of the federal lands were open to permitting and there was no issue. The EPCA study has helped focus the debate on the real areas of concern – federal lands available for multiple use and the restrictive lease stipulations that inhibit their use. But, even with this new information, it is likely that development opponents will try to minimize the very significant issues associated with land use stipulations. Similarly, they will try to divert attention toward concepts such as the “viable resources” approach created by the RAND Corporation. Taken to its logical conclusion the RAND approach would vest in the federal government development decisions that are now – and properly so – a part of the federal permitting process. The RAND approach should be rejected for what it is – a theoretical think tank white paper with little relevance to real world economic decisions. Congress needs to focus on the real issues and not allow these efforts at misdirection to confuse the debate.

It is equally clear that development opponents are undertaking an aggressive strategy of litigation to thwart access in the Intermountain West. When the EPCA study was released, the reaction was quick and certain:

"If you bid on a lease on public land, you can expect (environmental litigation)." – Peter Morton, The Wilderness Society, Dow-Jones Newswires, January 21, 2003

The federal government is now confronted with litigation threats and actions at every step in its process. Litigation has been filed to prevent exploration activities designed to identify possible resources. Litigation is filed over granting permits, challenging existing RMPs and opposing revisions to EISs. The primary result of this litigation is delay and more delay – and no new energy supplies. Delay is a key component of the strategy. Energy producers must invest capital, must replace and expand their production. If opponents to development can forestall access, it forces producers to shift their investment elsewhere. The longer producers are delayed, the higher the likelihood that they will give up on an area. This is the ultimate objective of this strategy of litigation, but it is ultimately a strategy that costs the nation domestic natural gas and impacts our energy security.

Producers are also confronted with a strategy of division – a strategy designed to build on the inherent conflicts that arise from different parties competing for the same space. One of these conflicts is the so-

called “split estate” issue. This is clearly an issue in the Intermountain West. With increased energy development activity, there are more opportunities for differences between producers and landowners or land users. Oil and natural gas producers understand the need to address this important problem. Producers are actively initiating efforts in states like New Mexico, Colorado, and Wyoming to develop better ways to address these relationships. Different approaches are being identified that reflect the unique circumstances in each state.

New Mexico provides an excellent example of these efforts. For the past eighteen months, the New Mexico Oil and Gas Association (NMOGA) has had a working committee with the ranching industry in the San Juan Basin. This committee, that meets monthly, has been identifying problems and working on solutions of surface use issues. It has, to date, formed thirteen separate road districts that are being individually addressed, along with the other areas including fencing and access roads as well as erosion.

NMOGA has also agreed to form a cooperative alliance with the New Mexico Cattle Growers Association. The purpose of this alliance is to work on identifying and implementing solutions to issues regarding split estate, ranching and private landowners. First, a committee will be formed to address the issues of historic pits and locations. This committee will be charged with identifying solutions and to identify and apply for funding mechanisms. In addition, the alliance will form several subject specific committees that will have the same goals as mentioned above and address such areas as roads, habitat fragmentation, erosion and reseeded.

In Wyoming, the Petroleum Association of Wyoming (PAW) is finalizing plans for the “Wyoming Split Estate Initiative,” which is designed to bring land owners and oil and gas producers together to facilitate cooperation and minimize disputes. PAW is working with the Wyoming Woolgrowers Association, Wyoming Farm Bureau and Wyoming Stockgrowers Association to find real solutions to this important issue. This localized initiative holds great promise to further promote cooperation between landowners and oil and gas operators and is another example of the efforts underway to address this matter.

The fundamental consistency between these efforts is the recognition by responsible producers that their working relationship with surface owners and users must continue to improve. Both parties have a right to reasonable access to the land and both must find ways to accommodate those rights. But, it is also clear that these tensions present opportunities for development opponents to try to drive a wedge between users of federal lands. Congress needs to approach these issues cautiously. The Intermountain West has become a battleground over the framework for domestic energy development; it has become a “no holds barred” fight. Legitimate issues are being intertwined with political agendas to thwart access to the natural gas resource base. Congress should certainly encourage resolution of legitimate conflicts, but it should avoid being pulled into the political use of these conflicts.

Energy Legislation Before Congress

With these perspectives on the challenges to meet current and future demand for natural gas as a reference point, the question becomes what issues should be addressed in energy legislation. The House of Representatives passed a number of key provisions in its version of energy legislation in the 107th Congress. That legislation provides a sound framework to build upon. Legislation in the 108th Congress should include:

§ Provisions for royalty incentives in the Western and Central Gulf of Mexico. It should parallel and extend the relief now being provided administratively in recent lease sales – those occurring after the House passed its bill.

§ Provisions to address deep drilling for natural gas on existing leases

§ Provisions to better assess the resource base in the offshore and possible mechanisms to access those resources.

§ Provisions to improve the efficiency of state consistency reviews for Outer Continental Shelf plans under the Coastal Zone Management Act.

§ Provisions for the Secretary of the Interior and the Secretary of Agriculture to jointly undertake a study of the impediments to efficient oil and gas leasing and operations on Federal onshore lands in order to identify means by which unnecessary impediments to the expeditious exploration and production of oil and natural gas on such lands can be removed. Such an analysis could provide policymakers with the information needed to address some of the key problems associated with the leasing process.

§ Provisions to ensure timely action on leases and permits reflecting the importance of the resource base underlying these lands on national security.

§ Provisions to create additional authority to develop RIK programs that will allow for more effective use of

the highly desirable approach. RIK eliminates the complexities of determining the royalty value thereby saving both the government and the producer from the convoluted determinations that are now necessary and are frequently questioned – sometimes years after the sales occur.

§ Provisions for royalty relief for marginal wells on both federal onshore and offshore properties for both oil and natural gas. This relief encourages the continued production of these wells in times of low oil and/or natural gas prices. Retaining production from these wells is in the national interest and the provision should be included in the final bill.

§ Provisions for the reimbursement through royalty credits when a private party pays for NEPA documents that are the responsibility of the federal government to prepare. Given the challenge of developing these key resources and the potential that adequate appropriations are not available, this is a common sense approach to meet the dual objectives of developing sound environmental documents and moving forward on permitting.

Collectively, these provisions would address many significant access and development issues. Final legislation needs to include them. Similarly, Congress needs to continue to work with the Administration to facilitate its efforts to improve the permitting process and to update its resource management plans. Money will be an important component of the Administration's efforts, but other authority may be necessary as well.

Thank you for the opportunity to provide this perspective on the challenges facing natural gas production in the United States.